

**HEARTLAND INSURANCE
RISK POOL**

JUNE 30, 2004

HEARTLAND INSURANCE RISK POOL

FINANCIAL STATEMENTS
with
REPORT OF CERTIFIED PUBLIC ACCOUNTANTS

YEAR ENDED JUNE 30, 2004

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REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Board of Trustees
Heartland Insurance Risk Pool

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of Heartland Insurance Risk Pool (the Pool) as of June 30, 2004, and the related statutory statements of income and surplus and cash flow for the years then ended. These statutory financial statements are the responsibility of the Pool's management. Our responsibility is to express an opinion on these statutory financial statements based on our audit. The financial statements of the Pool as of June 30, 2003 were audited by other auditors whose report dated September 26, 2003 expressed an unqualified opinion.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America, Chapter 11 of the Code of Iowa, and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described more fully in Note 1 to the financial statements, the Pool prepared these financial statements using accounting practices prescribed or permitted by Iowa Department of Commerce, Insurance Division, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of the Pool as of June 30, 2004, and the results of its operations and its cash flow for the years then ended, on the basis of accounting described in Note 1.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 15, 2004 on our consideration of the Pool's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

This report is intended solely for the information and use of the board of trustees of Heartland Insurance Risk Pool, the State of Iowa, the reinsurers of the Pool, and the Iowa Department of Commerce, Insurance Division and is not intended to be and should not be used by anyone other than these specified parties.

Conner Ash P.C.

St. Louis, Missouri
November 15, 2004

HEARTLAND INSURANCE RISK POOL

STATUTORY STATEMENTS OF ADMITTED ASSETS, LIABILITIES, AND SURPLUS

	June 30,	2004	2003
ADMITTED ASSETS			
Investments		\$ 4,288,564	\$ 4,918,822
Cash		479,136	274,459
Total cash and investments		4,767,700	5,193,281
Accrued interest receivable		22,868	62,647
		\$ 4,790,568	\$ 5,255,928
LIABILITIES AND SURPLUS			
LIABILITIES			
Reserve for losses and loss adjustment expenses (notes 3 and 4)		\$ 1,866,470	\$ 1,697,465
Other liabilities		22,450	19,300
TOTAL LIABILITIES		1,888,920	1,716,765
SURPLUS		2,901,648	3,539,163
		\$ 4,790,568	\$ 5,255,928

See accompanying notes and accountants' report.

HEARTLAND INSURANCE RISK POOL

STATUTORY STATEMENTS OF INCOME AND SURPLUS

Years ended June 30,	2004	2003
UNDERWRITING OPERATIONS (notes 2, 3, and 4):		
Premiums earned, net of reinsurance	<u>\$ 1,258,934</u>	<u>\$ 1,058,603</u>
Losses and loss expenses incurred, net of reinsurance	<u>1,680,474</u>	<u>1,160,141</u>
Underwriting expenses	<u>343,512</u>	<u>342,871</u>
	<u>2,023,986</u>	<u>1,503,012</u>
NET UNDERWRITING LOSS	(765,052)	(444,409)
INVESTMENT INCOME	<u>127,537</u>	<u>181,860</u>
NET LOSS	(637,515)	(262,549)
SURPLUS at beginning of year	<u>3,539,163</u>	<u>3,801,712</u>
SURPLUS at end of year	<u><u>\$ 2,901,648</u></u>	<u><u>\$ 3,539,163</u></u>

See accompanying notes and accountants' report.

HEARTLAND INSURANCE RISK POOL

STATUTORY STATEMENTS OF CASH FLOWS

Years ended June 30,	2004	2003
CASH FROM OPERATIONS:		
Net premiums collected	\$ 1,258,934	\$ 1,058,603
Net losses and loss adjustment expenses paid	(1,511,469)	(934,838)
Underwriting expenses paid	(340,362)	(341,971)
Cash used in operations	(592,897)	(218,206)
Net investment income received	166,289	147,717
Net cash used in operations	(426,608)	(70,489)
CASH FROM INVESTMENTS:		
Proceeds from investments sold or matured	2,105,846	2,882,297
Cost of investments acquired	(1,474,561)	(3,418,822)
Net cash (used in) provided by investing activities	631,285	(536,525)
NET CHANGE IN CASH	204,677	(607,014)
CASH AT BEGINNING OF YEAR	274,459	881,473
CASH AT END OF YEAR	\$ 479,136	\$ 274,459

See accompanying notes and accountants' report.

HEARTLAND INSURANCE RISK POOL

NOTES TO STATUTORY FINANCIAL STATEMENTS

June 30, 2004 and 2003

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Company operations

Heartland Insurance Risk Pool (the Pool) operates as a self-insured risk pool. The Pool was formed July 1, 1987 and provides insurance coverage to ten rural counties in Iowa.

The Pool self-insures workers' compensation, automobile liability, automobile physical damage, crime, and property lines of business on an occurrence basis. General liability, law enforcement, and public official errors and omissions coverage is written on a claims-made basis.

Basis of presentation

The Pool prepares its statutory financial statements in conformity with accounting practices prescribed or permitted by the Iowa Department of Commerce, Insurance Division. The statutory accounting financial statements are in accordance with the National Association of Insurance Commissioners (NAIC) *Accounting Practices and Procedures Manual*, subject to any deviations prescribed or permitted by the State of Iowa insurance commissioner. The Pool is currently applying only prescribed accounting practices. Statutory accounting practices, in accordance with NAIC *Accounting Practices and Procedures Manual*, vary in some respects from accounting principles generally accepted in the United States of America (GAAP) and include the following: (1) reinsurance recoverables on unpaid losses are netted rather than presented gross, (2) the statutory financial statements do not include a statement of comprehensive income, and (3) the statement of cash flows does not include classifications consistent with GAAP and a reconciliation of net income to net cash provided by operating activities is not provided.

The preparation of statutory financial statements in conformity with accounting practices prescribed or permitted by the Iowa Department of Commerce, Insurance Division, requires management to make estimates and assumptions that affect the reported amounts of admitted assets and liabilities and disclosure of contingent assets and liabilities at the date of the statutory financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

See accountants' report.

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - CONTINUED

Valuation of investments

Investments are comprised of certificates of deposit with varying maturities and are carried at cost, which approximates fair value. The cost of securities sold is based upon the specific identification method. Maturities were as follows at June 30:

	2004	2003
Less than 1 year	\$3,230,790	\$4,336,604
One to two years	1,057,774	582,218
	<u>\$4,288,564</u>	<u>\$4,918,822</u>

Premium income recognition

All policies have a twelve-month term and expire on June 30. As a result, all premiums are earned by the June 30 year-end and are reported net of applicable reinsurance.

Reserve the losses and loss adjustment expenses

The Pool provides liabilities for losses based upon undiscounted aggregate case basis estimates for losses reported; estimates of unreported losses based upon past experience, modified for current trends; and deductions of amounts for reinsurance placed with reinsurers. Losses are reported net of amounts recoverable from salvage and subrogation.

Income taxes

The Pool was formed under Chapter 28E of the Iowa Code and is tax-exempt under Section 115 of the Internal Revenue Code.

2. SERVICE AGREEMENTS

The Pool has an agreement with Arthur J. Gallagher & Co. to act as a service agent for the self-insured lines of business and provides administrative and loss control services. The Pool has another agreement with Alternative Risk Services LLC to provide claims services. The service fees for the years ended June 30, 2004 and 2003 were as follows:

	2004	2003
Claims services	\$105,000	\$110,000
Administrative services	140,500	135,000
Loss control services	67,600	65,000
	<u>\$313,100</u>	<u>\$310,000</u>

See accountants' report.

3. REINSURANCE

The Pool cedes insurance to other insurers in order to limit its maximum loss through risk diversification. Insurance ceded by the Pool does not relieve its primary liability as the originating insurer. The amounts deducted for reinsurance ceded were as follows:

	Direct	Ceded	Net
2004:			
Premiums written and earned	\$2,412,179	\$1,153,245	\$1,258,934
Losses and loss adjustment expenses incurred	\$2,556,967	\$ 876,493	\$1,680,474
Reserve for losses and loss adjustment expenses	\$2,609,263	\$ 742,793	\$1,866,470
2003:			
Premiums written and earned	\$2,034,160	\$ 975,557	\$1,058,603
Losses and loss adjustment expenses incurred	\$2,039,709	\$ 879,568	\$1,160,141
Reserve for losses and loss adjustment expenses	\$2,440,258	\$ 742,793	\$1,697,465

The basic ceded reinsurance treaties benefiting the Pool apply to risks on an excess basis. The base per occurrence retention levels of the Pool are as follows:

Policy period ended	Workers' compensation	Auto, law enforcement, public official and general liability	Property
Through June 30, 2002	\$350,000	\$250,000	\$ 50,000
June 30, 2003	\$350,000	\$350,000	\$100,000
June 30, 2004	\$500,000	\$350,000	\$100,000

The Pool does not have aggregate reinsurance for periods after June 30, 2002.

See accountants' report.

4. RESERVE FOR LOSSES AND LOSS ADJUSTMENT EXPENSES

Activity in reserve for losses and loss adjustment expenses is summarized as follows:

	2004	2003
Balance as of July 1, net of reinsurance recoverable of \$742,793 and \$511,161 in 2003 and 2002.	\$1,697,465	\$1,472,162
Incurring related to:		
Current year	1,460,155	1,122,807
Prior years	220,319	37,334
Total incurred	1,680,474	1,160,141
Paid related to:		
Current year	539,765	612,670
Prior years	971,704	322,168
Total paid	1,511,469	934,838
Balance as of June 30, net of reinsurance recoverable of \$742,793 in 2004 and 2003.	\$1,866,470	\$1,697,465

The reserving process relies on the basic assumption that past experience, adjusted for the effect of current developments and likely trends, is an appropriate basis for predicting future events. Reserve amounts are necessarily based on management's informed estimates. As other data becomes available and is reviewed, these estimates and judgments are revised, resulting in increases and decreases to existing reserves. As a result of changes in estimates of ultimate losses on insured occurrences in prior years, the Pool had an unfavorable development of \$220,319 and \$37,334 for 2004 and 2003, respectively. Development for losses and loss adjustment expenses on prior years vary significantly due to the small size of the Pool.

5. CONTINGENCIES

The Pool is subject to numerous lawsuits arising in the normal course of the insurance business. The Pool believes that the resolution of these lawsuits will not have a material adverse effect on its financial condition or its results of operations. The Pool has reserves which are believed adequate to cover any potential liabilities arising out of all such pending or threatened proceedings.

See accountants' report.



The Board of Trustees

Heartland Insurance Risk Pool:

We have audited the statutory financial statements of the Heartland Insurance Risk Pool (the Pool) as of and for the year ended June 30, 2004 and have issued our report thereon dated November 15, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, Chapter 11 of the Code of Iowa, and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Pool's statutory financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Pools' internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control over financial reporting. Our consideration of internal control over financial reporting would not necessarily disclose all matters in internal control over financial reporting that might be material weakness. A material weakness is a condition in which the design or operation of one or more internal control components does not reduce to a relatively low level of risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the Board of Trustees of the Pool, the State of Iowa, the reinsurers of the Pool, and the Iowa Department of Commerce, Insurance Division and is not intended to be and should not be used by anyone other than these specified parties.

Conner Ash P.C.

November 15, 2004